RS650-2

JAPAN · ECONOMIC · INSTITUTE

JEI REPORT

A Two-Part Report: A and B

NO. 2B
January 12, 1990

IN THIS ISSUE:

Yen Loses On Three Continents In 1989 1

LDP, Opposition Parties Test Waters
For Possible Coalition 4

Tokyo Adds To Impetus
For Cambodian Peace Settlement 6

Japan Defrosts China Ties 7

Japan-EC Update 9

Notes: SII Talks 10

Yen Loses On Three Continents In 1989

As experts sort out the events of 1989 affecting Japan, they may be struck by an apparent paradox. During the year Japan's economic performance continued to dazzle as its growth rate stayed comfortably ahead of almost all other industrial countries and fears of a Japanese economic juggernaut increased among Americans. And how did its currency do on world currency markets? The yen went down in value -- not just against the dollar but also against most European currencies and those of Japan's important trading partners in Asia.

The yen dropped 7.1 percent against the dollar during 1989 from its average 1988 level, reversing three straight years of significant advances (see Table 1). From the end of 1988 to last year's close the yen lost 11.8 percent. On the same basis the British pound was virtually the only major currency against which the yen managed to stay even, losing a scant 1.2 percent. This development was comparable to that of a recent world series champion suddenly sharing the cellar with a perennial also-ran. The yen also lost ground against the South Korean won, the Singaporean and the Hong Kong dollars and the New

Taiwan dollar, all of which were relatively unchanged against the U.S. dollar (see Table 2).

Table 1: Yen-Dollar Exchange Rate, 1984-89

(monthly average, Tokyo interbank market)

	1984	1985	1986	1987	1988	1989
January	Y234.0	Y254.1	Y200.0	Y154.5	Y127.6	Y127.2
February	233.7	260.3	184.6	153.5	129.2	127.8
March	225.5	258.4	178.8	151.5	127.3	130.4
April	225.0	251.7	175.6	143.0	125.0	132.1
May	230.7	251.6	166.9	140.5	124.8	138.4
June	233.3	249.0	167.8	144.5	127.1	143.8
July	242.7	241.7	158.7	150.2	133.1	140.7
August	242.2	237.2	154.1	147.6	133.6	141.1
September	245.2	236.9	154.8	143.0	134.4	145.1
October	246.9	214.8	156.0	143.5	129.0	141.9
November	243.3	203.9	162.7	135.3	123.2	143.5
December	248.0	202.8	162.1	128.4	123.6	143.6
Annual Average	237.5	238.5	168.5	144.6	128.2	138.0

Table 2: Changes in the Yen Against Selected Currencies, 1988-89

(other currencies in terms of yen at yearend)

	1988	1989	Percent Change
German Deutsche mark	Y71.55	Y85.18	-16.0%
British pound	229.61	232.30	-1.2
Australian dollar	108.05	113.68	-5.0
Canadian dollar	106.45	124.27	-14.3
Korean won	0.19	0.21	-12.6
Singapore dollar	65.06	75.74	-14.1
Taiwan dollar	4.50	5.52	-18.5
Hong Kong dollar	16.26	18.44	-11.8
U.S. dollar	127.00	143.91	-11.8

Since the now-famous Plaza Accord of 1985 the yen ordinarily had shared top honors with the West German Deutsche mark as the strongest industrial-country currency. During most of the subsequent period the yen has outperformed the Deutsche mark. By the end of 1989, however, the two currencies clearly had been decoupled. Analysts blamed political developments in both countries. In this respect they were about half right.

They exaggerated the effect of political events in Japan. Although 1989 certainly was a tumultuous year by Japanese political standards, with multiple scandals culminating in the Liberal Democratic Party's unprecedented loss of its majority in the upper house, the results on currency markets were questionable, at best. During the first seven months of the year, when most of the

turmoil occurred, the Japanese currency lost ground against the dollar, but the Deutsche mark was equally weak. And in the days following the July upper house elections the yen at least held its own. As late as August the yen was slightly stronger against the dollar for the year than the Deutsche mark.

The experts, however, were on firmer ground in offering a political explanation based on events in Europe. The accelerating pace of change in Eastern Europe, particularly in East Germany, decisively broke the connection between the yen and the Deutsche mark during the last three months of 1989. Just as the United States and Japan were mostly bystanders as the drama unfolded, their currencies took a definite back seat to those of European countries. Between October and the end of the year the yen hardly budged against the dollar, but both were weak against the Deutsche mark. Had the yen equaled the late 1989 strength of the Deutsche mark against the dollar, the Japanese currency would have ended the year very close to its all-time high of just over Y120=$1.00. Instead, it finished in New York at Y143.91=$1.00.

For the time being, the Deutsche mark obviously is benefiting from the euphoria over events in Eastern Europe. But its prospects over the next year or two depend on the size of capital flows into and out of West Germany, trade between the two blocs and the social costs of integrating the economies, to name only a few influences. Even if Eastern Europe gives the West German economy a big boost, the Deutsche mark could weaken. Positive economic developments do not necessarily bring in their wake a strong currency.

Japan provided proof of that assertion during the last half of 1989. As noted, the Japanese economy remained buoyant. Yet the yen hardly moved against the dollar in the face of interest rate increases in Japan and drops in the United States -- policy changes that normally would be expected to push the Japanese currency up. Continued economic growth, if anything, had a negative effect on the yen. Not only did widening labor shortages heighten inflationary fears, but imports continued to grow in tandem with the economy, reducing the trade surplus and thereby weakening a factor that normally would bolster the yen.

The drop in the yen's value during 1989 came as a modest surprise to many forecasters, who had expected the Japanese currency to rise slightly over the course of the year. Experts seem determined not to make the same mistake in their outlooks for 1990. An early January survey by Nihon Keizai Shimbun of 41 Japanese experts and 22 foreign analysts showed forecasters to be cautious. None was willing to say that the dollar would drop below it previous low of Y120, even temporarily, during the year. But several thought the dollar could be worth as much as Y160 sometime during 1990.

As a group the Japanese participants, drawn mostly from the ranks of business economists, were slightly more pessimistic about the yen than the others, mostly economists at American and European banks. The midpoint of the range of estimates by the Japanese polled was Y146, for the foreign analysts surveyed Y142. This suggests that the two groups felt that, while the yen would have its ups and downs, its 1990 average would be almost exactly the same as its 1989 yearend value. If the analysts could agree on anything, however, it was that this consensus forecast was wrong. Virtually everyone expected

considerable movement in the yen-dollar exchange rate in 1990; they just could not agree on the direction.

Douglas Ostrom

LDP, Opposition Parties Test Waters For Possible Coalition

The phrase "politics makes strange bedfellows" might apply to Japanese politics, depending on the outcome of the expected February 18 lower house elections. Anticipating what may be a fluid political scene following the House of Representatives contests, members of the ruling Liberal Democratic Party and some opposition parties have been floating the idea of an LDP/opposition coalition as a means of facilitating Diet action on a number of difficult issues.

The LDP's public approval rating has improved considerably since its trouncing in the July upper house elections, prompting Prime Minister Toshiki Kaifu to declare January 5 that the ruling party will win a majority when voters go to the polls next month. He also dismissed the notion that the LDP should contemplate a coalition government in the event his prediction proves overly optimistic.

However, senior party officials believe the chances of the ruling party hanging on to all of the 293 seats it currently holds in the 512-seat lower chamber are problematic. Of the factors that affected the House of Councillors' outcome, it still is unclear to what extent the electorate has "forgiven" the LDP for the involvement of some members in the Recruit Co., Ltd. influence-peddling affair. The ruling party's support among previously stalwart agricultural groups also has been weakened due, in part, to the LDP-led government's acquiescence to U.S. pressures that it decontrol beef and orange imports. But what may be the greatest area of uncertainty is whether the electorate will accept the ruling party's attempt to reform the controversial consumption tax (see JEI Report No. 46B, December 8, 1989).

For these reasons, certain senior LDP members have voiced an interest in a coalition with some opposition parties to ensure the continuation of a conservative-led government. "In order to guarantee political stability, we will have to consider forming a coalition," Takujiro Hamada, an influential LDP member, was quoted as saying recently. Former Prime Minister Noboru Takeshita, in fact, proposed December 14 that the LDP consider forming a "partial coalition" with some of the opposition parties. Masayuki Fujio, former chairman of the LDP Policy Affairs Research Council, endorsed Mr. Takeshita's idea, telling his Diet colleagues that this would facilitate better policy coordination. "Telling the [Japanese] people which way we are going to head is important to give them feelings of assurance," he reportedly stated. Although none of the trio explicitly mentioned Komeito or the Democratic Socialist Party as possible coalition partners, ruling party members have acknowledged that these two centrist-leaning parties are the most likely candidates.

Shin Kanemaru, former deputy prime minister and head of the Takeshita faction, came forward December 26 with an even bolder approach: formation of a "broad coalition government centering on the Liberal Democrats and the right wing of the JSP [Japan Socialist Party]." Like the former prime minister, Mr. Kanemaru, who has said that the ruling party's prospects of winning a comfortable majority in the lower house races are "tough," feels that forming a "grand